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The Political Repercussions of the Debt Crisis in Major LDCs

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The Assistant Chief of Staff for Intelligence, Department of the Army

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The Director of Intelligence, Headquarters, Marine Corps

The Department of Commerce

SCOPE NOTE

This Estimate examines some of the political repercussions of the debt crisis in the developing countries. It focuses on seven countries—Argentina, Brazil, Chile, Mexico, Nigeria, the Philippines, and Venezuela—whose debt to banks is large enough to constitute a potential threat to the stability of the international financial system and the servicing of which has created serious economic problems. Countries whose debt problems may be serious but not threatening to the system, such as Bolivia, are discussed only briefly. Countries that have been able to manage large debts without severe economic difficulties, such as South Korea, are not discussed.

The Estimate assesses the likely impact of debt-related economic austerity on political stability and policies in the debtor countries. It focuses particularly on whether and how much these political repercussions will constrain the ability of debtor-country governments to maintain economic adjustment policies and deal with their creditors.

For purposes of this paper we define political instability as that which causes radical changes in a government's policy or in the government itself.

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KEY JUDGMENTS

The severe economic repercussions of the debt problem in the major LDC debtors—declines of some 10 percent in GNP, of 15 to 20 percent in per capita real incomes, and of 40 to 60 percent in imports—have not yet caused serious political instability or basic changes in policy orientation for the governments of these less developed countries. But economic problems have generated political pressures that are substantially restricting the flexibility of these governments to undertake economic reforms and to deal cooperatively with foreign creditors, including the IMF.

If economic recovery proceeds in the next year or two, then debtor-creditor differences can probably be worked out through ad hoc adjustments by both sides. In the less likely case that economic recovery in the debtor countries is prevented by highly adverse external economic developments—stagnant or closed markets, higher interest rates, or reduced net capital inflows—the chances are that there would be defaults, severe financial disruptions, and major changes in the management of international debt.

Even if external economic conditions are reasonably favorable, many debtor countries will face continued economic austerity for many years in order to service their debt. These conditions will make political conflicts more difficult to resolve and could thereby contribute to major political upsets, such as a return to military rule in Argentina, the fragmentation of political power in Mexico, and the growth of leftwing violence in Chile and the Philippines.

Perhaps the key determinants of political reaction to prolonged austerity are how much populations expect of governments and the flexibility of any given political system. Where little by way of economic benefit is expected of government and/or where the populace is so cowed by its rulers that it dares not push for change, strong political reaction to economic hardships is less likely [redacted] 25X1
[redacted] When governments can successfully deflect much of 25X1
the blame from themselves onto less reachable targets—their predecessors, the bankers, the IMF, and so forth—they thus escape the fallout that can lead to serious political pressures or to political instability [redacted] 25X1
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In Brazil the 25X1
increasingly flexible political system and anticipation of a return to

civilian government have muted political reaction to the economic problems. The greatest likelihood of political instability arises when the sitting government is widely perceived as the main cause of the problems, as in the Philippines, where the Marcos regime plays such an enormous role in the nation's affairs. Likewise, the Nigerian Government is proving less and less able to deflect the blame away from itself, largely because the politically significant elites, particularly the military, have come to expect so many government benefits, the funds have dried up

Although most of the debtor countries are likely to begin a slow economic recovery this year or next, we think that their political resistance to austerity measures will build. As the shock of the financial emergencies of 1982-83 passes, and austerity measures are increasingly designed to restructure the economy to lay better foundations for future growth rather than simply to deal with the lack of foreign exchange, the necessity for sacrifices becomes less obvious, more debatable, and politically more difficult to implement.

Among the seven principal debtor countries that are having serious debt problems, *Brazil* probably is best placed to work itself out of its debt burden. Brazil is well positioned to sustain rapid and diversified export growth if it can keep its exchange rate competitive and if its foreign markets are expanding. Domestic political trends—a gradual process of democratization—reflect a broad public consensus and are unlikely to be upset even if the economy does poorly. But democratization does constrain the government's economic policy flexibility and consequently could lead to major problems in negotiations with foreign creditors. We expect the Brazilian Government to be able to continue a generally cooperative relationship with the IMF if external conditions permit economic recovery to proceed and the IMF continues to show flexibility. But, if external economic conditions turn sour and necessitate additional painful adjustment as political activity intensifies, Brazilian policy could quickly turn nationalistic and confrontational.

Mexico has made the most effective adjustment to the debt problem among all the major debtors. It has shifted from an enormous current account deficit to a large surplus, permitting a substantial buildup of foreign exchange reserves; it has also regained a degree of confidence among the banks, most of which have agreed to extend the period and ease the terms of rescheduling. Although it has started to recover, Mexico's economy remains depressed because austerity measures are restricting the public sector while low demand and lack of confidence have sapped the private sector. Strong leadership from President de la Madrid and effective use of the ruling party's organization have kept public dissatisfaction and political pressures under control. The government will not be able to tolerate for long, however, a

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situation in which economic recovery is held up by lack of demand while foreign exchange reserves accumulate. Mexico is already beginning to expand the public sector once again, a process that if continued could lead to policy differences with the creditors. Moreover, during the remainder of his term, de la Madrid will face rising pressures for reforms in the political system even if healthy economic growth resumes. Although the ruling party—the PRI—has demonstrated considerable resiliency, there is a potential in the longer term for serious political instability to develop in Mexico—in the form of fragmentation of the PRI and growing opposition to the system—which would reduce the government's ability to negotiate constructively on matters of importance to the United States, such as trade, energy, and emigration, and could lead to serious domestic polarization and violence.

In *Argentina*, the inability of the political system to develop any sort of consensus on policy was the fundamental cause of poor economic performance in the past and will be the principal barrier to a resolution of the debt problem in the future. The Alfonsin government's dominant priority is to establish a democratic political system firmly in Argentina in hopes of eventually facilitating consensus. The nationalism, fractiousness, and impatience of the Argentines will make it difficult to forge such consensus, however, and hence impair the government's ability to implement conditions of the tentative IMF agreement. The difference between IMF criteria and what the Argentines can live with can probably be bridged, at least temporarily. There is a high risk of miscalculation, however, which over time could lead to a direct confrontation and perhaps to a breakdown of negotiations. The chances of such a breakdown are low, however, even though Argentina would be better able than other debtors to live with the consequences of default—its exports being readily marketable without identifying the source and some possibly shiftable to the USSR. Moreover, Argentina will almost certainly be unable to meet the conditions required by the IMF. Thus, debt crises will recur periodically. If interest rates do not increase and foreign demand for Argentine exports is strong, there is a reasonable chance that these crises will be worked out. In a less favorable external situation, or if the government appears to have been forced to take unpopular steps by its creditors, Argentina would soon be unable to service its debt. [redacted] 25X1

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Chile, despite having made perhaps the most painful adjustments among all the debtor countries, faces a severe foreign exchange

constraint because its interest costs are growing more than its exports, which are depressed by low copper prices. The military government, although still able to impose its authority, has become more sensitive to public opinion as a result of recurrent public demonstrations and widespread discontent. It is following mildly expansionary economic policies, which, if they are continued and if external conditions do not soon improve, will put Chile out of conformity with the IMF conditions for loans. In any event, the political opposition to the Pinochet government (though badly split) is so widespread that it cannot be bought off by the limited economic carrots available to the government. And, if economic conditions do not improve, in the longer term, violent leftwing opposition may grow.

Although *Venezuela* is going through a fairly severe economic adjustment, it is buffered by a democratic political system that often results in weak governments but also in considerable stability in policies, by still substantial foreign exchange reserves, and by a high standard of living. The outlook is for continued economic stagnation, which could cause some erosion of political stability, but is unlikely to trigger major political upsets in the foreseeable future.

By contrast, *Nigeria* will continue to encounter highly unstable political conditions and probably have a series of military coups. Economic factors contribute to this instability—both the past oil boom, which fed enormous corruption, and the present economic depression, which is causing large-scale unemployment and declines in real wages—and conditions are unlikely to improve substantially in the next few years. Basic ethnic and regional rivalries and competition for a stagnant economic pie will be the major factors fueling this instability.

In contrast to the other major debtors, which have already made severe economic adjustments and whose economies have probably bottomed out, *the Philippines* began its economic adjustment to the debt problem only a few months ago and its economy is certain to decline substantially more before it hits bottom. The debt crisis is not the primary cause of President Marcos's political problems, but the economic recession is creating rallying points for the opposition. Even with an agreement with the IMF and debt restructuring, private sector confidence will remain low, and it is highly unlikely that Marcos can build a solid basis for future economic recovery. Moreover, as long as Marcos retains power he cannot deflect most of the blame from the system he established and controls. Thus, the potential for political instability in the Philippines is probably almost as high as in Nigeria over the next few years.

In general, we expect numerous conflicts between debtors and creditors during the next year or so. Rather than let these conflicts lead

to confrontation or ultimate default, debtors and creditors are likely to agree on various ad hoc arrangements to ease the debt service burden. Although there will be recurring crises and substantial arrears on payments of interest, it is unlikely, except under highly adverse international economic conditions, that any major debtor country will formally repudiate its obligations or be called in legal default.

Neither the debtors nor the creditors want to run the high risks default would entail. But these risks might appear acceptable if external conditions were unfavorable, especially for Argentina, which is less vulnerable to creditors' actions than many other debtors.

We believe that debtor-creditor conflicts will be ad hoc and bilateral. Debtor interests are too diverse to provide a basis for formation of any sort of cartel except under extremely unfavorable economic conditions, which might induce the largest debtors, Brazil and Mexico, to cooperate. However, consultation and communication among debtors will continue to grow, and political pressure on the creditor countries to give a higher priority to debtors' needs in their fiscal, monetary, trade, and aid policies will become far stronger.

This political pressure will come mostly from the so-called Cartagena Group of 11 Latin American debtors (including all the large debtors). We expect the Cartagena Group to work out common objectives, strategies, and tactics to use especially in international forums. Its major objectives include lower interest rates, open markets for LDC exports, some sort of cap on the debtors' interest burden, rescheduling repayments over long periods, and increased funding for international financial institutions. Agreement on such objectives, however, does not limit any debtor country's freedom of action and is unlikely to result in any joint actions on debt negotiations.

Even if, as we expect, major confrontations between debtors and creditors are avoided and workable compromises reached, the United States will continue to be blamed by many debtor governments for contributing to their problems. This political fallout from the debt problem will continue to complicate US relations with many of the Latin American debtors, which have high and sometimes unrealistic expectations of the US Government's ability to influence the IMF and the banks.

DISCUSSION

1. Many less developed countries, including nearly all of those in Latin America and seven of the eight largest debtors—Argentina, Brazil, Chile, Mexico, Nigeria, the Philippines, and Venezuela—have been unable to meet their debt service obligations without large reductions in imports and economic activity. Real incomes and employment have fallen sharply for most segments of the population. Riots, strikes, and more peaceful protests have occurred in most of these debtor countries, and resentment toward the International Monetary Fund, the bankers, and the United States has been rising. This resentment is epitomized in Argentina President Alfonsin's statement on 6 February 1984: "I cannot visualize the absurdity that our creditors think we must wreck our economy in order to pay them." (See text inset and tables 1 and 2.)

Development of the Debt Problem

2. For some time, many of the debt-plagued LDCs had been following highly expansionary economic policies that were unsustainable. In the early 1980s the LDCs were caught in a scissors hold between surging interest rates, which reflected a fundamental shift in Western, especially US, economic priorities, and falling export earnings, which resulted from a combination of prolonged recession and disinflation. These trends, on top of the large increase in oil prices in 1979-80, transformed a manageable problem into a severe crisis and capital flight became massive. Creditors lost confidence first in countries, such as Mexico, that had been following inappropriate economic policies and consequently were running large deficits in domestic budgets and foreign payments. But the loss of confidence soon spread to many other debtor countries, including nearly all of Latin America. By the end of 1983, 25 countries had been forced into rescheduling their debts, and most of these had agreed to economic adjustment programs under the aegis of the IMF.

3. The debtors had no choice but to make drastic adjustments. A combination of declining export earnings, high interest payments, and capital flight drastically reduced the ability of the debtor countries to finance imports. Between 1981 and 1983, in 15 debt-ridden LDCs:

- Imports fell by $50 billion, or 40 percent for the group as a whole and by more than 50 percent in Mexico, Argentina, Chile, and Nigeria.
- Exports fell by $14 billion, or more than 10 percent, mostly because of lower prices.
- The trade surplus increased by over $40 billion.
- The current account balance improved by over $50 billion.
- And, despite this improvement in the current account, these countries lost some $10 billion in official reserves.

4. In 1983, imports were at or near the lowest level of the past decade in relation to gross domestic

Some Debtor Country Statistics

The severity of the debt problem in major LDCs is illustrated by the following statistics:

- The debt totals reached about $100 billion in both Brazil and Mexico in 1983 and ranged from 20 to 75 percent of GDP among the major debtors, with Chile having the highest ratio.
- Scheduled debt service (principal and interest) takes up about three-fourths of the total exports of goods and services in several of the major countries if only medium- and long-term loans are considered. If short-term debt is included, debt service obligations exceed export earnings in all but Venezuela and Nigeria.
- Interest obligations alone make up 30 percent or more of export earnings in Argentina, Brazil, Mexico, Chile, and Peru.
- With the net flow of capital to LDCs declining sharply and, in the cases of Mexico, Nigeria, and Venezuela, shifting to a net outflow, interest payments have been financed in effect by the LDCs' own foreign exchange earnings rather than by foreign capital.

Table 1
Debt Profile in Major Debtor Countries

Size of Debt (1983)	Billion US Dollars (End of Year)	As Percent of GDP	As Percent of Exports of Goods and Services
Argentina	43	30	445
Brazil	101	50	415
Chile	19	75	395
Mexico	98	70	335
Nigeria	15	20	90
Peru	13	80	330
Philippines	23	65	295
Venezuela	34	50	195

Debt Service (1983) as Percent of Exports of Goods and Services	Excluding Short-Term Principal Payments	Including Short-Term Principal Payments
Argentina	70	104
Brazil	75	170
Chile	61	129
Mexico	65	181
Nigeria	21	39
Peru	65	120
Philippines	41	160
Venezuela	31	80

Ratio of Scheduled Interest Payments to Exports of Goods and Services (percent)	1980	1982	1983
Argentina	27	47	40
Brazil	33	50	43
Chile	21	40	34
Mexico	29	37	31
Nigeria	3	8	10
Peru	19	29	30
Philippines	14	29	28
Venezuela	15	21	20

product in major debtor countries. Inevitably, these major import cuts were accompanied by substantial declines in economic activity and even larger declines in per capita real income (table 2). Between 1981 and 1983:

— GDP fell 4 to 15 percent in Mexico, Argentina, Chile, the Philippines, and Nigeria.

— Because current account deficits had shrunk, real domestic expenditures fell even more than GDP, by 10 to 20 percent in the same countries.

— Per capita expenditures were down 15 to 30 percent from the 1980 or 1981 peak to a level well below the late 1970s in most of the debtor countries.

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Table 2
Macroeconomic Trends in Major Debtor Countries

	1978-80 Average	1981	1982	1983
GDP (1981=100)				
Argentina	97	100	95	96
Brazil	96	100	101	98
Chile	88	100	86	85
Mexico	86	100	100	94
Nigeria	99	100	97	92
Peru	100	100	101	90
Venezuela	101	100	101	96
Expenditures per Capita [a] (1981=100)				
Argentina	104	100	89	87
Brazil	100	100	97	87
Chile	86	100	76	66
Mexico	87	100	90	80
Nigeria	97	100	96	79
Peru	102	100	95	88
Venezuela (1980)	96	100	102	73

Imports (c.i.f.)

	Billions US Dollars			1983 as Percent of 1981
	1981	1982	1983	
Argentina	9.4	5.3	4.5	48
Brazil	24.1	21.1	16.8	70
Mexico	24.1	15.1	8.0	33
Chile	6.4	3.5	2.8	44
Venezuela	13.1	12.6	8.7	66
Nigeria	20.9	15.1	8.5	41
Peru	3.4	3.6	2.5	74

[a] GDP plus imports, minus exports.

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— Although investment took the largest cuts, consumption also declined substantially, as a result of falling real wages and growing unemployment.

5. In the course of the past several years, all the major debtors (except Nigeria and Venezuela) turned to the IMF for help in restructuring their debt service schedules, for loans, and for help in arranging new loans from their creditors. While each IMF agreement differs in specifics, in general the Fund has required internal as well as external policy changes—a reduction in public deficits and in the money supply or in inflation as well as currency devaluation to realistic levels, plus trade surpluses and an increase in international reserves.

6. Creditor banks and governments have linked their new credits and rescheduling programs to the IMF, which has become the linchpin of the entire system. New IMF funding has been made conditional on net new lending from the banks to several LDCs. The banks in turn make disbursements on their loans contingent on the debtors' observance of IMF conditions. bank regulators, at least in the United States, are making the existence and observance of an IMF

program a major factor in classifying outstanding loans on which some terms are not being observed. And the US Government has made negotiation of a program with the IMF a condition for some of its loans.

7. The linkages to the IMF are not as strong in the case of rescheduling private debt as in the case of provision of new credits. In Venezuela and Nigeria, however, neither of which apparently will accept IMF conditionality, the banks are in the process of rescheduling nonguaranteed outstanding debt to protect their interests. In the countries that have accepted IMF programs and consequently are receiving new money, reschedulings, although separate, are influenced by the degree of success in following the IMF program.

8. The IMF's involvement in a large number of programs, each of which is closely linked to the programs of creditor banks and governments, while providing a degree of policy coherence to debt rescue attempts, also tends to reduce flexibility. In 1983, 34 IMF arrangements were initiated, as compared with 19 in 1979. Although the programs differ, they generally involve similar performance criteria. Obviously, in negotiating these conditions, the IMF must worry both about the impact of its decisions on other creditors of the country in question, and about the precedent for its other debtor-country programs. In short, the IMF must preserve its credibility, but this limits its flexibility in formulating programs to deal with the unique conditions of particular debtor countries.

Medium-Term Economic Prospects

9. The decline in imports and production appears to have stopped (in 1983 or 1984) in the major debt-troubled countries, except in the Philippines. But the adjustment process is far from over. For one thing, unless interest rates turn down and there is a sustained boom in the industrial countries, it will take years for most of the major debtors to regain their former levels of per capita income. For another, most debtors cannot hope to achieve economic recovery and real growth without undergoing some major changes in economic structure, because real interest rates are likely to remain much higher than they were in the 1970s, and net foreign investment in these countries, is likely to be substantially smaller, at least until confidence returns and recovery seems to be well under way. These shifts will require greater efforts to export and to generate domestic savings to enable the debtors to finance increased imports. And, without significant gains in imports, most debtors cannot hope to revive economic growth.

10. The critical domestic factors in raising exports will be highly competitive exchange rates, a reduction of fiscal and regulatory disincentives, and additional investment. These measures are not easy to implement and sustain. Although Brazil, for example, has maintained competitive exchange rates over the past year or so by continuous devaluation, other debtors, notably Nigeria, have refused to follow this course and there has been some erosion of earlier gains in Argentina and Mexico.

11. External economic conditions also have great importance in the way the debt problem will evolve, especially economic growth in the OECD countries; movements of commodity prices, particularly of oil; the level of net new lending to the various debtors; and world interest rates. For illustrative purposes, we have considered two possible scenarios: one "optimistic," which projects conditions favorable to the debtor countries; and one "pessimistic," which assumes that the world economy goes badly off track. In the "optimistic" scenario, the debtor countries' exports grow rapidly as a result of strong economic growth in the industrial countries. In this generally favorable environment, it is also assumed that the net inflow of foreign capital will increase, thanks to a return of more normal trade credits, an end to capital flight, and some increase in foreign direct investment. In the "pessimistic" scenario, debtor country exports grow slowly or stagnate because world economic conditions are depressed, and the net capital inflow is assumed to decline further. In both scenarios, nominal interest rates are assumed to remain at the 1984 level. Although interest rates may rise (a 1-percentage-point increase in interest rates would reduce import capacity by 2 to 3 percent in the seven major debtor countries), it is unlikely that a substantial, lasting increase in interest rates could be associated with a weak world economy—even if higher interest rates became a major cause of an economic downturn, the reduced credit demand associated with the downturn would tend to bring rates down. By the same token, a strong economic expansion is likely to keep credit markets firm. We have also assumed that oil prices would remain steady. If they were to rise, the outlook for economic recovery in the major oil-importing debtors—Brazil, the Philippines, and Chile—would worsen, while the oil-exporting debtors—Mexico, Nigeria, and Venezuela—would be better off. If oil prices were to fall, the opposite would occur.

12. The rates of change in import capacity—that is, the level of imports that the countries could pay for under each of the two scenarios—are shown in table 3. Although events are likely to evolve in between the two scenarios, the chances are that they will be closer

Table 3
Projected Import Capacity [a]
of Major Debtor Countries

	Billion US Dollars					Annual Percentage	
	Average 1978-81	1983	1984	1985	1986	1985	1986
Optimistic scenarios							
Argentina	6.8	4.1	4.5	5.7	6.4	+27	+12
Brazil	19.2	15.5	15.5	21.0	27.7	+35	+32
Chile	4.8	2.8	3.5	3.2	4.2	−8	+31
Mexico	15.8	7.7	9.5	17.4	21.7	+83	+25
Nigeria	14.3	7.2	9.5	13.4	13.3	+20	−1
Philippines	6.6	7.5	6.2	7.2	8.1	+16	+12
Venezuela	11.0	6.8	7.3	10.2	11.0	+40	+8
Pessimistic scenarios							
Argentina				2.5	2.5	−44	0
Brazil				17.0	20.6	+10	21
Chile				2.2	2.1	−37	−5
Mexico				14.6	14.9	+54	+2
Nigeria				9.5	9.5	0	0
Philippines				6.2	6.3	0	0
Venezuela				9.4	9.4	29	0

[a] Imports f.o.b.

to the optimistic one than to the pessimistic one. Most official and private forecasts are fairly close to, although somewhat below, the optimistic scenario. For the pessimistic scenario to occur, the growth of the economies of the industrial countries would probably have to slow to a rate of 1 to 2 percent in 1985-86, which is well below any current major forecast. It serves as an illustration of the potentially serious consequences of an economic downturn.

13. Calculations show wide variations in the outlook for import capacity among countries, which result partly from differences in the magnitude and timing of each country's economic adjustments:

— Mexico can substantially increase its imports initially unless oil prices fall greatly, but the longer term outlook is for slower import growth.

— Brazil has the potential to increase its export earnings rapidly but needs strong and open foreign markets and a sustained competitive exchange rate to realize this. Its imports could begin to recover rapidly as early as 1985 under favorable conditions.

— Argentina, with less dynamic export prospects, will be unable to regain anywhere near past import peaks, even under favorable conditions, and may face the necessity of further import cuts if interest rates rise and the capital inflow is reduced.

— Chile faces continued severe economic difficulties unless there is a surge in the price of copper, which seems highly unlikely. Its economy is extremely vulnerable to variations in foreign markets, interest rates, and capital flows.

— Nigeria can increase its import capacity only if it can raise the volume of its oil exports.

— Some recovery is likely in Venezuela in 1984, but longer term prospects are for little if any import growth.

— The Philippines did not begin its economic adjustment until late in 1983 and will have to take more painful measures in 1984.

14. The relationship between imports and GDP is too variable in all the LDCs for projections of import capacity to provide a sound basis for projections of economic growth. Nevertheless, it seems highly likely, at least in most of the countries, that imports will have

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to increase substantially faster than GDP during the next several years. In Argentina and Brazil, the ratio of imports to GDP constant prices in 1983 was the lowest, or one of the lowest, in more than a decade, and in several countries import shortages have been causing disruptions of economic activity. Moreover, in all the debtor countries, investment is much more import dependent than consumption, and has declined far more than consumption, although the recent data are poor. To sustain an economic recovery beyond a year or two, investment will have to rise substantially, and consequently imports too will grow rapidly.

15. With the many uncertainties in mind, the following generalizations as to economic growth prospects in the principal debtor countries seem indicated:

— All the economies, except that of the Philippines, bottomed out in 1983 or early 1984 and most will probably grow slowly (1 to 3 percent) in 1984.

— A healthy economic recovery (4 to 6 percent annual growth) could begin in 1985, except in Venezuela and Nigeria, but only under highly favorable external conditions.

— If external conditions are not favorable, significant economic recovery would be postponed to 1986 or later.

— Economic performance in Venezuela and Nigeria will depend almost exclusively on oil exports, the outlook for which is not bright.

— Even if rapid economic recovery begins soon, the 1980-81 per capita levels of expenditures will not be regained until the late 1980s at the earliest.

16. The implications of delayed economic recovery for employment and real wages are grim when the labor force is growing 2 to 3 percent a year, as it is in nearly all the major debtors. Unemployment reached unprecedented levels in most of the major debtors in 1983. Real wages fell sharply. Nutrition, education, housing, and health services—all of which showed significant improvement in the 1970s—suffered severe setbacks. Compared with those of more prosperous years, crime rates are up markedly in major cities such as Rio de Janeiro, Sao Paulo, Buenos Aires, Manila, Lagos, and Mexico City. Thus, the general level of well-being, however measured, for many or most of the inhabitants of the debt-plagued countries has fallen markedly since the beginning of this decade, although, given the expansion of the informal or underground economies, probably not as far as the statistics would indicate.

Impact of Economic Austerity on Political Stability

17. Despite enduring prolonged recession and austerity, few major debtors have so far experienced marked political instability attributable to the economic hardships. Leaders of the military coup that ended civilian rule in Nigeria last year blamed the civilian government for food shortages and rising inflation, but we think that rampant corruption was probably the major reason for the coup. Elsewhere there have been riots, strikes, and violent demonstrations but they have not produced political instability or even major policy changes designed to head off such instability.

18. Since there is no generally accepted theoretical framework that explains the myriad connections between economic development and political reactions, we cannot be certain about how much austerity a people will accept without severe political reactions. Logic indicates, however, that only a highly authoritarian LDC government would or could deliberately choose indefinite postponement of economic growth without risking its own future. We also recognize that economic conditions are not the only factor that can produce political instability. Indeed, particularly in the Philippines and Chile, discontent long antedates the recent debt crisis and subsequent austerity.

19. Nevertheless, there are some generalizations about austerity and instability that help illuminate the outlook for a number of major debtor countries. First, there is no discernible direct link between general economic conditions and political stability.[1] Moreover, political protests—strikes, riots, demonstrations—do not necessarily lead to political instability, that is, to threats to the government or its basic policies. Indeed, such protests may serve as a safety valve that defuses underlying anger or suffices to reverse an onerous policy change like reduction of the subsidy on bread.

20. Second, in many countries there appears to be a significant distinction between the political impact of general economic deterioration or recession that can be attributed to impersonal forces (effects of the business cycle, or drought, or change in the terms of trade) and the political impact of a government-initiated austerity program. Adjustment programs—whether self-imposed or IMF mandated—usually require specific and painful policy changes like a reduc-

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tion of subsidies and government spending, higher taxes, or restrictions on wages. Such changes have an identifiable impact, clearly stem from open governmental acts, and thus offer much better defined targets to protest.

21. Third, reaction to government activities will be stronger the more these actions appear to reflect the governments' own choices rather than being driven by external events. For example, tax and wage changes will often generate more political heat than the imposition of drastic exchange controls when the country has run out of foreign exchange reserves. By the same token, measures taken at a time when a financial situation has eased a bit will be politically more difficult than the same measures taken in an obvious crisis situation.

22. Political reactions to painful government economic measures also depend on how accustomed the population may be to such measures—devaluations are normal in Brazil but rare and more painful in the Dominican Republic, where a recent devaluation triggered serious riots and violence; or on how well the measures are managed and explained; or on their specific effects (cutting food subsidies in Egypt, for example, produces instant riot); and, of course, on how unpopular the government already is.

23. Finally, perhaps the key determinants are how much populations expect of governments, and how flexible the political system is. The most stable and least worrisome situation is where little by way of economic benefit is expected of government and/or where the populace is so cowed by its rulers that it dares not push for change. [redacted] in most of the debtors, existing governments have been able to deflect much of the blame from themselves onto less reachable targets—their predecessors, the selfish developed world, the bankers, the IMF, etc.—and thus escape much of the fallout that can lead to serious political pressures or to political instability. [redacted] While Brazilians clearly blame their government for some or much of the economic problem, a tradition of compromise and political flexibility, coupled with anticipation of a return to democracy, has muted political reaction. In the most unstable countries, the sitting government is widely perceived as the main cause of the problems, as in the Philippines, where the Marcos regime plays such an enormous role in the nation's affairs. Nigeria is also likely to prove highly unstable because the politically significant elites have come to expect so much from government largess—and funds for such benefits have been dramatically reduced. We doubt that the present government or any likely successor will be able to remedy the situation any time soon.

24. It is in such countries and in others which may be moving from relative passivity into this dangerous stage that threats to political stability and/or to existing policies of playing by the debt-servicing rules seem to be greatest. When a sitting government is blamed for implementing onerous conditions dictated by its creditors (especially if they produce sudden shocks like a leap in prices of staples), for grossly mismanaging national affairs, or for sinking into unacceptable levels of corruption (as in Nigeria and the Philippines), public discontent is more likely to evolve into effective political pressure or into political instability.

25. Conditions in a number of major debtors highlight the potential for such shifts. The postelection honeymoon in Argentina may be waning, Mexican labor is likely to push harder against wage restraint while the middle class seems to be focusing more on corruption and mismanagement. Peruvians and Chileans seem to be shifting more blame onto their own governments. This, in turn, argues strongly for rising intransigence on the part of some debtor governments seeking to deflect blame.

Brazil

26. Of all the major debtors, Brazil, the largest, has the best prospects of weathering current and near-term austerity while avoiding significant political instability or radical changes in economic policies. Compared with most of their neighbors, Brazilians have a generally high tolerance for imperfect government performance. As the process of democratization, or *abertura*, continues over the next several years, we expect the level of interest in and expectations from the political process to grow, but we do not expect sudden or drastic changes in the political landscape.[2]

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27. The Brazilian economy is broadly industrialized, fairly flexible, blessed with a variety of resources, and not highly dependent on foreign trade. The recession appears to have bottomed out in late 1983 or early 1984, and Brasilia has thus far met IMF condi-

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tions for 1984 far better than had been expected by most observers at the turn of the year. There appears to be a growing feeling among the economic-financial-commercial community that the worst is over. Given at least moderate growth in its export markets and reasonable exchange rate policies, Brazilian exports can probably increase fast enough to permit imports to recover in the next several years, provided net new lending continues at modest levels. This, in turn, would permit growth to resume and, after a short lag, per capita income to grow again, although it would take several years, perhaps into the early 1990s, to make up for the 15-percent decline that has occurred.

Economic Adjustments and Policy Choices

28. Brazil's severe debt problem is the legacy of policies during the 1970s that were highly successful in sustaining high rates of economic growth through the two large oil price hikes. The 7-percent average rate of GDP growth during the period 1974-80 was not far below the extraordinary 10 percent achieved in 1968-73 and was one of the highest in the world. But, although exports continued to do well, they could not cover the enormous rise in the cost of oil imports—up from 10 percent of imports in 1972 to 40 percent in 1980—and of interest payments. To cover its payments, Brazil had to borrow abroad on an enormous scale. At the same time, efforts to substitute domestic production for imports and to subsidize exports, while continuing economic growth by expanding financing of public enterprises, caused worsening economic distortions.

29. The recession began in 1981 and intensified in 1982 and 1983, when GDP fell about 3 percent; as the current account deficit was slashed, domestic expenditures declined 10 percent. This year GDP is expected to increase 1 to 2 percent. Clear signs of improvement in living standards, however, are unlikely for at least another year.

30. Although the economy is no longer contracting, the management of Brazil's debt problem will be politically more difficult for at least the next year or two. Brazil is meeting IMF conditions—thanks partly to IMF flexibility on monetary targets. Nevertheless, it will face some severe economic policy conflicts, which are likely to create new strains with the IMF. IMF demands for further cuts in the public sector deficit will run counter to growing domestic pressure to stimulate general economic recovery as popular impatience with austerity builds:

- Meeting IMF internal economic conditions will require a substantial slowing of inflation, which is unlikely if wages continue to grow faster than called for in the price-wage indexing law. But wage increases well below the rate of inflation would encounter strong popular resistance.
- Funding of public enterprises (parastatals) will conflict with the needs of private business for access to credit under IMF-prescribed limits on total credit. If cuts in the public sector deficit prove insufficient to slow inflation substantially, the private sector will continue to be squeezed out of the credit market. Consequently, economic recovery may be held back.

31. These policy decisions will be far easier if external economic conditions are favorable than if they are unfavorable. If import capacity grows rapidly and, by 1985, the overall economic recovery is well under way, domestic stabilization measures can be taken without hurting any important segment of the population. But, if domestic policy moves affecting income distribution are attempted in a stagnating economic environment, political resistance would become stronger.

Political Dynamics

32. Until very recently, the Brazilian political system allowed its leaders considerable latitude in formulating economic policy and imposing some painful measures. Many years of military/technocratic rule, during which the government has used forceful measures to quiet dissent, combined with a politically acquiescent society experiencing broad economic gains, resulted in remarkable political stability—an avoidance of drastic or sudden policy changes.

33. Labor is fragmented and disorganized, more concerned with job security than with wage gains. Political parties are shallow rooted and basically nonprogrammatic, focused more on a specific leader than on ideology. Parties, as such, have never been powerful; the two main ones are both heterogeneous and fractious. There are no coherent political extremes, on either the left or the right. Political power has rested with the active military and their technocratic colleagues, allied with a large number of retired military officers who run most of the large parastatal concerns that dominate the economy. The private sector has had little political clout. Even Congress has been weak.

34. Under this system, Brazilians tolerated and adjusted to fairly drastic cuts in their real incomes, perhaps because few saw any other feasible options, although confidence in the economic leaders has declined markedly. While crime has risen sharply in

urban areas, and there have been periods of protests and supermarket lootings in the major cities of Sao Paulo and Rio de Janeiro, they do not represent or express organized opposition. Even the more political, middle-class demonstrations earlier this year in favor of direct presidential elections were peaceful.

35. Moreover, a wide spectrum of Brazilians seems resigned to the military regime's carefully paced program of democratization. Although the recent talk of speeding up the timetable and instituting direct elections next year was very popular, demonstrations and other pressures for such a move were peaceful. Now that this option has been precluded for the 1985 election, attention is again focused on the candidates' chances in the electoral college, where political alliances are fluid and engender much popular speculation.

36. Neither candidate stands far from the center; neither has advocated drastic policy change. Yet the very opening up of the political process is likely to put more constraints on the future leaders of Brazil. The political horsetrading that will lead to the selection of the next president has given Congress more clout. Its first major success was in refusing to ratify government decrees last fall that reduced wage indexing. While it eventually went along with a milder measure, it had tasted some power. Whoever assumes the presidency on 15 March 1985 will have to pay even more attention to Congress and to the people it is coming to represent; the increased necessity for political bargaining will reduce his power to impose unpopular measures.

37. Thus, Brazil's leaders will hesitate, even more than in recent years, to further dramatically reduce subsidies or cut the parastatals' budgets, because a confrontation with Congress could either block the measures or lead to government paralysis, eventually creating conditions that might draw the military back in.

38. Given these political pressures, meeting IMF conditions for internal Brazilian policies, especially further reductions in the budget deficit and inflation, will be difficult even if favorable external conditions enable economic recovery to get under way. Meeting IMF conditions would probably be impossible if economic recovery were delayed—for example, because creditor banks refused to continue net new lending, or export growth were seriously impeded by economic stagnation or protectionism among OECD countries.

39. Under such circumstances, we think the external actors—foreign banks, the IMF, the industrial countries—would be blamed far more than would the domestic leadership. This in turn would lead at least to increasing pressures for debt renegotiation and a reduced debt service burden. At worst, it could produce a unilateral moratorium on debt service until matters could be rearranged. In sum, we think that Brazil can peacefully endure the next year or so of recovery and under favorable external economic circumstances will make serious efforts to play by the rules of the international financial game. But we doubt it would or could continue to do so if hopes of recovery and growth were severely dampened by external factors.

40. We think the outlook is similar over the longer term. If external economic conditions are favorable, Brasilia will probably continue to muddle through its economic difficulties, achieve at least some structural reform, and regain a reasonable rate of economic growth without encountering severe domestic political pressures. The progress of *abertura* toward more democracy and direct presidential election under a revised constitution is likely to raise both public interest and confidence in the political process. If, on the other hand, there is a marked economic downturn in the industrialized countries or if interest rates rise sharply in the United States, Brazil's next president will face much more congressional resistance to the restraints on wages and further budget cuts that would probably be required to service the debt. Under such conditions, we would expect Brazil to become more nationalistic and probably confrontational vis-a-vis creditors, arguing that it had done all it could on the domestic front. But, apart from more difficulty in debt renegotiations and in trade and investment issues, we would not expect Brazil to pose additional foreign policy problems for the United States.

41. In neither case do we expect Brazil to make radical policy shifts or encounter serious political instability. The military, though it will move to the background, would prevent the former and, if necessary, repress the latter.

Mexico

42. The odds are good for Mexico to work its way through the next year or so without serious political instability or dramatic economic policy changes. Mexico made an earlier and more drastic economic adjustment to its debt problem than any of the other large debtors; as a result, Mexico is running a large surplus in its foreign payments, and consequently has more flexibility in its economic policy options than most of the debtors have. Moreover, Mexico has a strong government capable of making and implementing

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decisions, having been ruled by a single, well-organized, and reasonably dynamic party for over 50 years.

43. At the same time, the Mexican political system is coming under more strain. The president plays a large and highly visible role in national affairs. He, the party, and the government appear to get much more of the credit or blame for what happens in Mexico than is the case in Brazil. The oil boom of the 1970s produced not only rapid economic growth but also major socioeconomic changes in Mexico. In fact, the very rapidity of change under the dominant Institutional Revolutionary Party (PRI) has sowed the seeds for more pressures for change.

44. Between the end of World War II and 1981, the Mexican economy grew 5 to 6 percent per year while managing to avoid the recessions that periodically afflicted most other LDCs. Toward the end of the 1970s, buoyed by booming oil revenues, Mexico embarked on a program of headlong economic expansion—largely within the public sector—financed by oil sales and heavy borrowing abroad. At the same time the government expanded generous subsidies to both local producers and consumers (on food, transport, and public services) which also raised the fiscal deficit. Moreover, a fixed nominal exchange rate let the peso appreciate in real terms and boosted imports. To keep these policies intact in the face of weakening oil prices in 1981, Mexico continued to increase foreign borrowing, mainly in short-term loans, and its foreign debt exceeded $80 billion. The crisis—the first major one among LDC debtors in this series—came in August 1982 when Mexico City had to suspend payment on about $2 billion a month in debt service.

45. When President de la Madrid took office in December 1982, the initial shock was over, the rescue effort was under way, and he could implement the austerity measures required by the IMF during his political honeymoon. The result was a sharp recession that hit virtually all sections of Mexican society but one that resulted in plaudits from the creditors and sizable new credits. Mexico is one of the few major LDC debtors meeting IMF conditionality requirements, in particular having reduced the public sector deficit from 18 percent of GDP in 1982 to 8.7 percent in 1983, and targeted 6.5 percent for 1984. On external payments, Mexico shifted drastically from a current account deficit of nearly $14 billion in 1981 to a surplus of $5.5 billion in 1983, enough to allow a $3 billion increase in official reserves. But the costs, in terms of economic pain, have been very high, particularly for the private sector and the middle class.

46. Since 1981, Mexico has undergone one of the sharpest economic adjustments of any major debtor country. Tight exchange controls and drastic devaluation cut imports as much as 70 percent, industrial production and employment fell about 20 percent, real wages about 30 percent, and investment more than 50 percent. There are indications that the economic slide has stopped, but few signs of recovery are visible yet.

Economic Policy Choices

47. The extraordinary reversal in Mexico's current account balance has given the government a substantial buffer and a much wider range of economic policy choices than other major debtors have. Last year's current account surplus was equal to about 70 percent of merchandise imports and the increase in foreign exchange reserve to nearly 30 percent of imports. In 1984 or 1985 a substantial rise in imports could be financed even though increases in interest payments are likely to absorb much of the likely growth in export earnings.

48. At this point, what is holding back economic recovery is insufficient aggregate demand, not the availability of foreign exchange. With employment and real wages down sharply, consumption is depressed. Public investment has been cut sharply, although a small increase is planned for this year. Private investment is severely depressed because of lack of demand, excess capacity, and the still substantial, although somewhat reduced, burden of government controls and regulations. Nonoil exports, even though expanding, are still too small to become a major source of economic recovery. With IMF guidelines calling for further reductions in the public sector deficit, and with wages continuing to lag at least slightly behind inflation, it is difficult to identify any strong sources of economic recovery any time soon.

49. This situation presents the government with difficult policy choices. Domestic political pressure to reflate the economy is building but to do so on a large scale would put IMF support and the goodwill of foreign banks at risk. Reflation via increased public investment has already begun; if this process continues, it will eventually increase the public sector deficit. Such policies would be criticized by the IMF, and Mexico would probably lose its ability to raise new voluntary bank loans. On the other hand, the Mexican Government cannot afford for long to tolerate severely depressed economic conditions, especially at the same time that it is accumulating foreign exchange reserves.

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50. Beyond the next year or two, Mexico's economic performance will depend heavily on the extent to which exports can be diversified and the private sector encouraged to develop. Should Mexico continue to rely on public sector expenditures to sustain growth, its economy is unlikely to be anywhere near as dynamic as in the 1970s, because of the poor outlook for oil earnings. To a degree there is a trade-off between short-term and longer term economic growth. Building up the private sector may mean restraining economic recovery this year and next year, while laying the foundations for more rapid continued growth later. But the political obstacles to such a course are daunting.

Political-Social Dynamics and Constraints

51. Mexico's half-century-old system of government by one authoritarian party, based on a broad coalition of interest groups, has thus far proved remarkably resilient and adaptable, co-opting or suppressing most dissidence and providing continued benefits to the growing federal work force and the rising middle class. The PRI regime's total control over patronage and the distribution of material awards has been perhaps its most powerful asset in maintaining its monopoly on power.

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52. But the very success of this system has generated or hastened political-economic changes that are now creating unprecedented challenges. Economic development has spurred the growth of an educated, sophisticated middle class, of the private business sector, especially in the northern cities close to the US market, and of a new group of PRI leaders and officials dubbed technocrats in contrast to the more traditional political bosses. Moreover, Mexico's high population growth rate produces hundreds of thousands of entrants into the labor force annually. Most are not employed in union jobs, many are semi-employed or illegal migrants in the United States. Both economic and population growth have also contributed heavily to the very rapid increase in urban slums and shantytowns, which have a high potential for riots or violent protest, particularly if faced with sudden increases in the price of staples or losses of public services. Moreover, rapid economic gains by the urban middle class and northern (largely private) business interests have increased these elements' influence, and spurred unprecedented growth and local election victories of the conservative opposition party (PAN).

53. Perhaps even more ominous has been the spillover from the oil wealth. The sudden spurt of oil revenues, public development projects, and other spending greatly increased the opportunities for corruption on the part of public officials to levels far beyond those traditionally practiced and accepted in earlier decades. The economic downturn that began in the early 1980s focused additional popular attention on these excesses as most Mexicans began to feel the pinch of economic austerity.

54. A final danger: the Mexican political system depends heavily on a strong and effective president, yet it lacks a tested mechanism for replacing him should he be unable to serve his full term. In many senses, the president is the focus of politics—his performance and lapses are key factors in public expectations and perceptions of government. No matter how effectively de la Madrid deals with his economic and political problems, his sudden departure from the scene could trigger considerable confusion and infighting over the succession and undermine public confidence in the system and in Mexico's economic prospects.

55. In the past, significant social and political groups gave the PRI and the system credit for Mexico's economic growth. But it is now becoming increasingly clear that many in the middle class at least show signs of being more dissatisfied with the corruption, mismanagement, and rigidity of their political system in the aftermath of the 1982 shock and subsequent recession. As time passes, the present administration will find it more and more difficult to focus such criticisms on its predecessor without being tarred by the same brush.

56. The chances are that the Mexican Government will try to follow a middle course, involving cautious domestic reflation without departing too widely from IMF policy recommendations. This strategy will probably prove successful, at least for the next year. We see little evidence that political pressures are building up to the point of either forcing major economic policy shifts or threatening a breakdown of central government authority. In the longer term, however, policy choices will be narrowed, both by the likely buildup in domestic political pressures and by the likely reduction in balance-of-payments flexibility as imports recover while export growth slows. Even if a foreign exchange bind is avoided, the reaction in Mexico to any adverse trends in international interest rates or foreign markets will significantly affect the political feasibility of a policy that sacrifices short-term recovery for lasting longer term benefits.

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57. We doubt that the private sector will succeed in becoming Mexico's new engine of economic growth because the PRI's statist preferences are of long standing and the private sector lacks confidence in government promises. If it does not, then political pressure for more rapid expansion of the public sector will become irresistible. In that case, the economy is likely to stagnate or grow only slowly, while the President and the existing political system incur increasing blame for Mexico's problems.

58. We are less sanguine about the prospects for Mexico over the longer run. The outlook for the economy is for slow growth at best because Mexico cannot hope to expand exports rapidly (barring a major rise in oil prices, which we do not expect). Moreover, we expect the efficiency and cohesiveness of the PRI and perhaps of the political system at large to erode. The key determinants of political stability will include the President's success in managing the economy, his leadership capabilities, and his ability to control corruption.

59. We do not foresee a genuine strengthening of the political system. This would require a restoration of the PRI's past popularity and effectiveness, a major drop in the general level of corruption, and the integration of disparate interests—represented by the relatively prosperous north, oriented toward the United States, and the increasingly impoverished rural and southern areas—into some sort of national consensus. It would probably also require steady economic recovery and growth. Nor do we expect a general decline into civil anarchy, although that possibility cannot be ruled out.

60. We think the most likely developments over the rest of this decade will be gradual erosion of popular support for the leadership, and growing dissatisfaction on the part of urban labor, the middle classes, and the private sector. As popular support wanes, the Mexican Government is likely to resort to more nationalistic and anti-US rhetoric in an effort to avoid blame and regain more political unity. This would undoubtedly impinge on Mexican attitudes toward US goals in Central America and would probably affect many other ongoing issues between the United States and Mexico.

Argentina

61. The outlook for Argentina, the third-largest debtor, is highly uncertain. Argentines are fiercely nationalistic when dealing with the outside world. Political instability and inept governments have been the rule, not the exception, over the past 30 years largely because interest groups are unusually powerful and have seldom been willing to perceive a national interest that was more important than their immediate particular goals. Labor, dominated by the Peronist opposition, is especially powerful and generally unwilling to postpone satisfaction of immediate demands for the sake of a more prosperous future.

62. Argentina's newest experiment with democracy, which began last year with a fair election that produced a new, non-Peronist government, offers the best hope for political stability in many years. President Alfonsin entered office with broader support than most of his predecessors. The civilian opposition is in considerable disarray, and the military are thoroughly discredited after their years of repressive and inept rule. The new government has moved slowly and cautiously to consolidate its position, and come to terms with labor and the military. It has not focused on economic policy beyond promising sustained economic growth and making halfhearted attempts to curb inflation. It has been adamant on a critical point—that economic recovery cannot be sacrificed to pay debts. Thus, the prospects for Argentina appear to hinge on Alfonsin's political skills in handling the conflicting domestic interest groups, all of them unaccustomed to compromise, while gingerly introducing more order into an economy ravaged by inflation at over 600 percent per year.

63. The apparent conflict between IMF conditions and economic growth is most clearly articulated in Argentina; political dynamics weigh heavily against sustained austerity; and at least some major political figures appear to think that Argentina could survive in default as well as or better than it could by trying to pay its enormous debts. We do not expect Argentina to go into default, but the odds on default are higher there than in any of the other major debtors.

Genesis of the Present Problem

64. Argentina is potentially a rich country. Its problems stem largely from a chronically unstable political system. From 1946 until 1983 the Peronist party won every national election it was allowed to enter. The opposition parties saw no chance of taking power in democratic elections, and the only way the Peronists could be ousted when confidence in their rule faded was by military coup. When Peronists were in power they tended to promote labor benefits and protect domestic industries. When the military were in power, they sought to undo the damage, open the economy to outside forces and markets, and foster exports. As a

result of these stop-and-go policies, internal and external confidence in Argentina's prospects has remained low. Thus, for decades, Argentina has been plagued by very slow growth, bouts of severe inflation, and loss of confidence. GDP is currently at about the level of a decade ago and per capita GDP at the level of two decades ago.

65. In the late 1970s and early 1980s, Argentina borrowed heavily abroad to finance a major public investment program and cover foreign payments deficits. At the same time, the military government held currency devaluations below the inflation rate to encourage import competition. Private firms and individuals also borrowed to cover import bills and in some cases to build foreign nest eggs. By the end of 1981, Argentina's debt service burden (principal and interest) had grown to about three-quarters of its export earnings. The Falklands war (April-June 1982) was the final blow to lender confidence and new lending stopped. Argentina reached agreement with the IMF in January 1983, was out of compliance by midyear, and only recently came to a tentative new agreement with the Fund.

Political Dynamics and Constraints

66. The government of President Alfonsin, inaugurated in December 1983, represents more hope for Argentina and for its creditors than was expected before the October elections. For one thing, by winning an absolute majority (52 percent) of the votes Alfonsin avoided a protracted process in the electoral college. For another, the size of the vote indicated surprising support for the Radical presidential candidate. Finally, the free and open election of a non-Peronist government restored hope for real change in Argentine political life and has been a major factor in reviving the country's self-confidence.

67. The Radical government faces several very difficult problems at the same time: (1) the economy and the debt burden; (2) relations with the military; and (3) relations with the labor unions. Inflation is now running at the rate of over 600 percent a year, government deficits are enormous, and payments on the external debt cannot continuously be postponed without a new agreement with Argentina's creditors. Any agreement with the IMF will require at least some austerity for Argentina's working and middle classes over the next several years. It would almost certainly involve lowering inflation and government deficits, and holding down increases in real wages and imports while expanding exports. None of these measures is likely to be popular. While the Radicals have the lead in the lower house (Chamber of Deputies), they do not control the Senate. Moreover, at least some of their strength represents not pro-Radical but anti-Peronist voters, who may or may not be willing to follow through on tough measures.

68. Relations with the armed forces represent a problem of almost equal magnitude for the new government. Alfonsin campaigned on the promise to bring to justice those senior officials responsible for crimes against civilians during the antisubversive campaign of the mid-1970s (during which thousands "disappeared" and were killed). The new government has already taken some steps against the guilty military personnel and raised concerns within the military establishment as to how far it will go. At the same time, Alfonsin has sharply reduced military spending. While the armed forces are now discredited and show no signs of preparing to intervene in the political process, their history of doing so repeatedly means that Alfonsin cannot ignore this possibility in the future.

69. Finally, the Peronists themselves—especially given their traditional labor supporters—also represent a serious problem for the Alfonsin government. Peronist leaders appear deeply divided as to what their course as the opposition party should be and they have little effective control over the rank and file. But Alfonsin failed last March to get Senate approval for a reform of the Peronist-dominated unions which he hoped would lead to a more moderate labor leadership. This failure, in turn, has meant delicate and prolonged efforts to contain union power and elicit at least tacit support for efforts to reduce the budget and inflation. The crux of this problem is Alfonsin's promise that real wages will rise—a promise likely to be impossible to keep, yet one that is politically very potent. In recent months, the Argentine Government has emphasized a more realistic objective—that real wages for the poorer workers will not be cut. With luck and political skill, this may offer an adequate face-saving way out of the wage dilemma, but so far the Peronists have refused to compromise and strike activity has intensified. These problems with labor will continue to complicate the broader problem of dealing with the foreign creditors and the IMF.

Relations With Creditors

70. The Argentine political scene guarantees that negotiations with the IMF and the banks will continue to be difficult. Implementation of an agreement with the IMF will require prior agreement with the banks on both rescheduling and new loans. Even if such agreements are reached, the chances that Argentina

will be able to conform to IMF conditions for long are low, and subsequent negotiations with the banks for new loans will probably require months.

71. Alfonsin now realizes he must take measures to stabilize the economy—especially to drastically reduce inflation—for domestic reasons. Without stabilization, he cannot reasonably hope to sustain economic growth. But he wants stabilization to be as painless as possible, and consequently has pushed and will push the creditors hard for all the concessions he can get.

72. Alfonsin probably has the political clout to sell the stabilization program to the Argentine people, even to gain tacit labor support, if he can present it as an essentially Argentine program—any program that appeared to be "imposed" by the IMF or the creditors would trigger opposition so strong that it probably could not be implemented. Appearances are of critical importance: real differences between Argentina and the creditors probably can be papered over in the hope that they can eventually be worked out.

73. Even under favorable external economic conditions over the next year or so, Argentina is unlikely to meet IMF conditionality for long, given the powerful domestic political pressures for economic growth and the nationalistic attitudes of the Argentines. There will probably be repeated renegotiations of debt service terms and policy conditions, although there is a reasonable chance that problems can be worked out. But if external economic conditions deteriorated, making it necessary to cut imports further to cover debt service, we think Argentina would probably stop paying interest on its loans and accept being called into default if necessary, although it would not itself repudiate the debt. Although the Argentine Government does not want the high economic costs, risks, and probable isolation that default would bring, it is aware that Argentina, virtually self-sufficient in food and energy and exporting mostly readily marketable agricultural products, is less vulnerable to creditors' sanctions than any other major debtor.

74. The outlook for Argentina is even less clear than for most of the other major debtors. If President Alfonsin is lucky and skillful enough to get a consensus on the course Argentina should follow, he might be able to implement drastic but short-term measures sufficient to reverse the inflationary trend and restore domestic and creditor confidence. We think the chances for such an outcome are well under 50-50, but, if it occurs, then US-Argentine relations would be likely to remain good, and Argentina would have a good chance to weather the debt crisis and resume economic growth.

75. The more likely outlook is for a continuation of various efforts to slow inflation and revive investment and real growth that fail to achieve their goals—that is, a real increase in tax revenues and cut in public spending. Under such circumstances, Argentina could muddle along for several years from "debt crisis" to "debt crisis."

Chile

77. Opposition to the Chilean military junta's rule is broad and deep. Much of it antedates the current economic troubles, which are adding further impetus to public protests, strikes, and violence. Even this military government, which has long ruled by force and with the tacit support of conservatives and moderates who fear the far left even more than authoritarianism, is now constrained to soften its austerity policies in the face of public protests and the gloomy economic outlook.

78. Chile's economic situation is among the worst of all the large debtors. It suffered the sharpest recession of any of the major debtors in 1982 and, although the economic decline appears to have stopped, many key banks and firms are in poor financial condition. With the largest external debt of the major LDCs in relation to GDP (75 percent) and a heavy reliance on exports of minerals, especially copper, Chile has been facing extremely difficult external economic conditions. Unless interest rates turn down or the downward trend in copper prices is reversed, increased interest payments will more than offset the likely increase in export earnings in 1984.

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79. These conditions give the Chilean Government no attractive options and very little room to maneuver. It can choose to stay within the IMF guidelines and hope that the resultant slow economic growth and high unemployment would be politically tolerable or that protests could be contained. In this event, it would probably retain IMF support and get at least some net loans from the banks to cover the current account deficit. Or it could turn away from its free-market orientation and fiscal restraint in order to stimulate more growth and reduce unemployment through public spending. These policies could not be sustained, however, because they would almost certainly produce inflation and current account deficits above IMF targets and endanger Chile's relations with its creditors.

80. Whichever course Chile chooses, and the odds favor the greater public spending option, President Pinochet and his economic team are likely to be blamed increasingly for the economic misery and to seek to deflect that blame onto the IMF, the bankers, and the US Government. In recent months, Pinochet has changed his economic team and appears to be changing his views on orthodoxy and honoring debt-servicing obligations at all costs.

The Economic Problem

81. Over the past decade or so, Chilean economic policies have shifted drastically from the socialism of President Allende to the free market of the successor Pinochet regime. In 1975, Chile experienced a deep recession as copper prices fell by half while the economy had to adjust to the sudden shift to market-oriented policies in which price controls and subsidies were virtually ended. Then, during 1976-81, Chile enjoyed one of the longest booms of this century—average growth of 7 percent, with inflation declining from nearly 400 percent to about 20 percent. The combination of this return to prosperity, harsh rule by the Pinochet-led military junta, and middle-class fears of the disruptive power of the left served to dampen political opposition to authoritarian rule.

82. In 1981, a series of external shocks and Chilean responses to another dramatic fall in copper prices (copper accounts for nearly half of Chile's exports), lower prices for other exports, the sharp increase in international interest rates, and the virtual end to capital inflows, while Santiago persisted in maintaining full wage indexation and an overvalued peso and failed to monitor the fragile domestic banks, led to the sharpest recession of any among the major LDC debtors. Between 1981 and 1983, GDP fell by about 15 percent, real domestic expenditures fell roughly one-third, and imports dropped by about half, while unemployment, particularly in manufacturing and among skilled professionals, rose markedly.

83. The recession probably bottomed out around mid-1983. Agreement with the IMF in early 1983 and a rescheduling of commercial bank debt in midyear for 1983 and 1984 provided some new loans and some stability in external accounts. Sluggish or declining copper prices, higher interest rates, and a severely depressed private sector added to the pressures for measures to spur the economy, even at the expense of continued compliance with the IMF's conditions.

Political Dynamics and Constraints

84. Chile is perhaps the most highly politicized of all the South American nations. Popular ferment, fueled in part at least by the recession, appears to be building. The rightist parties (and much of the middle and upper classes) still support Pinochet as the bulwark against the Communists. The latter condemn and attempt to sabotage any attempts at dialogue between the government and the moderate opposition, which itself is fragmented.

85. Last year saw a dramatic rise in popular protests, which have carried over into 1984. Pinochet dallied with the moderate opposition, allowing some concessions such as permitting the return of several thousand exiles, but remains adamant about not speeding up the return to democracy. As the recession continued, he shuffled his cabinet last spring, replacing his finance and economy ministers (in the midst of delicate negotiations with the IMF) in what many see as a move toward an increased government role in reviving the economy—one that would involve higher budget deficits and thus require greater leniency from the IMF. We believe that Pinochet has come to see the economic situation as a significant threat to his rule, and is inclined to deal with domestic discontent by trying to improve economic conditions rather than by accelerating political liberalization.

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87. On the political front, all the ingredients for increasingly violent protest and repression seem to be present. We see little chance that the large but divided opposition to Pinochet can force peaceful change any time soon. We doubt that Pinochet will end his stubborn refusal to speed up plans for elections and a return to democracy (now scheduled for the end of the 1980s) or make other significant concessions to the moderate opposition. The chief question is whether his stance will induce so much protest that the junta will be impelled to replace him with a less intransigent chief who is willing to make greater concessions and move faster toward elections. [redacted]

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Venezuela

Economic Trends and Issues

88. Venezuela was one of the earliest victims of the OPEC disease. Over the past several decades, both its people and its government grew used to lavish spending and an expanding public sector. Economic and later financial mismanagement contributed heavily to the present situation. Government dependence on oil revenues and emphasis on grandiose investment projects (in steel, petrochemicals, fertilizer, etc.) enlarged its role in the economy to the detriment of agriculture and private enterprise. Venezuela now must import about half the food and consumer goods that it uses. Oil provides about 95 percent of export earnings, about two-thirds of central government revenues, and about a quarter of GDP. The public sector—including a number of expensive and highly inefficient public enterprises—employs about a third of the labor force and accounts for about half the country's GDP.

89. During 1982 the current account deteriorated significantly, reflecting mainly the impact of the world oil surplus, while the public enterprises and financial institutions continued short-term borrrowing for capital projects as well as current expenditures. External public debt grew to nearly $30 billion, over half of which was due in 1983. In the early part of 1982, Venezuelan authorities sought to refinance through a series of medium-term jumbo loans at small spreads, but delayed too long and missed the opportunity when the Mexican crisis of August removed that possibility. Thereafter, despite an increasingly apparent need for formal rescheduling, Venezuela delayed and temporized, awaiting elections at the end of 1983, while capital flight reached enormous proportions and foreign exchange reserves fell sharply.

90. Venezuela devalued the bolivar in February 1983 and established a cumbersome triple exchange rate system and tight exchange controls that cut imports by half and temporarily almost halted servicing of private sector debts. Caracas demanded and subsequently received repeated moratoriums on principal repayments because it declared it politically impossible to accede to IMF conditions before the national elections in December of that year, although it has met most of its interest obligations on public sector debt.

91. The new government of President Lusinchi's Accion Democratica (AD) inherited an economy in recession. GDP was essentially stagnant in 1982 and probably fell almost 5 percent last year. Because of the sharp cut in imports, however, total consumption expenditures in real terms have had to be cut substantially. In recent months, Lusinchi has obtained enabling legislation and begun to cut the government's deficit, mainly by slashing investment expenditures, and to reorganize and shrink some of the parastatal concerns, while trying to protect at least the poorest urban workers from large cuts in real incomes. His program won the grudging informal blessing of the IMF, an approval sought by Venezuela's creditor banks before they would negotiate on rescheduling the outstanding debt, while avoiding recourse to an IMF rescue program.

92. This avoidance of IMF conditionality has proved politically popular, as has Lusinchi's campaign to attack the extensive public corruption that had prevailed during the previous regime. Thus far, at least, the new government has proved more cohesive and effective than had been expected by many observers at the turn of the year. Moreover, Venezuela and its creditor banks have reached a general agreement to stretch out debt servicing over a fairly long term; the banks agreed, at least in part, because the Lusinchi government has adopted many of the IMF recommendations.

Political Constraints and Prospects

93. Venezuelans in general and organized labor in particular have not yet reacted much to the economic crunch and mild austerity program outlined by the new government. During the election campaign, neither party faced or discussed the problem of longer term stagnation (GDP is at about the 1978 level). [redacted] 25X1
[redacted] observers detected a profound 25X1
unease in the body politic—a sense that democracy in Venezuela has not produced good government or much economic progress. But this unease does not

seem to be translating into factors provoking political instability.

94. The major current constraints on Lusinchi's ability to implement his economic program is the reaction of urban labor. Here, the AD's long association with labor is proving helpful; union leadership recognizes the need for wage restraint and will try to support the program. But some problems between the government's economic team and labor have already arisen over price increases for basic essentials. The austerity program calls for wage restraint over the next year or so while various price controls, import subsidies, and other controls are reduced. This will put considerable additional strain on labor leaders' efforts to restrain wage demands.

95. We doubt that government-labor relations can remain as smooth as they have been in the first half year of the new administration. Instead, we expect a growing confrontation that will probably cause the government to back down at least somewhat on wage restraint in return for union leaders' help in channeling and controlling protest, particularly in urban areas. This, in turn, would be likely to spur inflation and cause more concern on the part of private business and the middle and upper classes. But we do not expect major unrest or political discontent over the next few years, despite the prospects for very slow growth.

96. There are several contingencies, however, which, though not very likely to arise, could alter this relatively sanguine political-economic outlook. A marked drop in the price of oil (say $5 per barrel) would make debt servicing nearly impossible, unless labor accepted large cuts in real wages. The political reaction would be strong and would probably include massive urban unrest and protests. Another prolonged standoff with the creditor banks in which the latter demanded significantly greater annual payments than Venezuela has offered would probably provoke at least more stonewalling on Caracas's part and might lead to a moratorium on payments. We think it highly unlikely that Venezuela would turn to the IMF for help in view of the widespread popular dislike of externally imposed conditions. Finally, the Lusinchi government could prove to be as inept, corrupt, and complacent as its predecessor. In this case, we would expect faltering implementation of the mild austerity measures now planned, much more rapid inflation, further capital flight, and generally deteriorating economic conditions. We think the resulting hardship for a people long used to a pretty confortable life would polarize Venezuelan politics and produce extensive social unrest that probably would reduce Venezuela's ability and will to service its debt.

97. Over the longer run, the outlook for Venezuela is for economic stagnation without much political reaction—a succession of basically similar elected governments as long as the real price of oil remains about the same. If the economy were to fall into a deep and prolonged recession, however, we think the odds for serious urban unrest and marked political instability would rise, perhaps enough to impel the military to step back into power.

The Philippines

98. The Philippines entered its debt crisis much later than most of the other major debtors, and the crisis was caused more by creditor fears of political instability and by economic mismanagement than by external factors like the oil shock and world recession. For much of the past decade, Manila has run current account deficits, both borrowing heavily and using up foreign exchange reserves. Creditors became increasingly concerned about the growing debt burden as well as about the erosion of key economic and political institutions under President Marcos's rule. Their confidence was further shaken last year by the growing signs of political unrest and virtually collapsed in the wake of the assassination of opposition leader Benigno Aquino in August 1983. Widespread and prolonged protest demonstrations followed this event, and Marcos's relations with key interest groups, including the business community, were damaged. The unity of the military and of the ruling party apparatus were also adversely affected.

99. In the aftermath of the assassination, capital flight (long a problem) grew enormously, apparently led by the immensely rich businessmen who dominate the economy in what Filipinos call "crony capitalism." At the same time, many banks refused to roll over credits and trade financing dried up. In October, Manila announced a 90-day "standstill" on principal falling due, devalued the peso (for the second time that year) by 21 percent, and began to put foreign exchange controls in place. Strikes, protests, and other indications of political instability further alarmed creditors. Thereafter, Manila muddled along through one moratorium after another, implementing some austerity measures (subsidy cuts, import restrictions, budget cuts, etc.) but not enough to satisfy the IMF or the creditors. The need to await the parliamentary elections (14 May 1984) was cited as a compelling reason not to move toward austerity (especially another major devaluation) before then.

100. Now that the elections are over, the options open to the Marcos regime are even less palatable than they were a year ago. In some respects at least, the elections were a defeat for Marcos personally although his party retains a majority in parliament and he has much latitude to rule by decree. The elections were relatively free (by Philippine standards) and produced a much stronger showing for the opposition parties than had been expected. Marcos thus lost some of the aura of invincibility that had so long sustained his rule. What is likely to be severe economic austerity for several years now will add to the depth and extent of this opposition.

101. Manila introduced some economic measures after the elections—a small budget cut, higher taxes, higher prices on petroleum products—and agreed to float the peso. But preelection spending, financed by expanding the money supply, has spurred inflation to about 60 percent a year, and the IMF, probably annoyed by earlier procrastination and shenanigans with financial records submitted to it, has insisted on implementation of these measures before reaching a standby arrangement. The creditor banks, moreover, have shown little faith in Marcos's willingness to undertake more than patchwork solutions and will be slow to extend new loans.

102. By September, with foreign exchange reserves at record lows, Manila finally reached agreement with the IMF on an 18-month economic adjustment program under which the Fund will extend a $615 million loan. In return, Manila must float the peso, raise new tax revenues, restrain the growth in the money supply, and dismantle the coconut and sugar monopolies.

103. The lack of foreign exchange will continue to force further cuts in imports and hurt employment, particularly in urban areas over at least the next few months. Further devaluation will hit the overprotected domestic manufacturing sector, and reductions in government spending are likely to affect subsidies, as well as the pay of government employees, and the military budget.

104. Even with an IMF agreement, the Philippines thus faces a period of difficult economic adjustment that will be politically painful. GDP will decline at least 5 percent this year, and probably fall again next year. With imports likely to be cut further, investment expenditures will drop drastically and there will be substantial reductions in real consumer incomes.[4]

105. The outlook for the Philippines is thus for continued economic stagnation at best and for growing political instability. We believe Marcos will seek to delay and dilute the economic measures required by the IMF and the other creditors because they will be politically painful to so many groups—his business cronies, urban labor, the peasants, and even the military, whose morale is already low. Failure to comply with the IMF program would, in turn, further decrease the confidence and willingness of the creditors to make new loans. And, without loans and a restoration of confidence, the economy will remain in recession. Further arrearages and difficult debt renegotiations seem inevitable.

106. The more critical question, however, is whether the Philippines will enjoy enough political stability to be able to continue to muddle through the economic problems. Confidence in Marcos's regime is eroding rapidly, and opposition is building. He cannot deflect the blame for the economic mess, the corruption, and the military atrocities that accompany attempts to counter the leftist insurgency, without making major changes in the way he governs the country. We doubt he will make such changes because they would almost certainly reduce his power and probably lead to his ouster. Moreover, his further disability or death could and probably would set off a long and destabilizing struggle over the succession.

107. In any event, recession and prolonged austerity can only feed the widespread discontent with his regime and increase the appeal of the far left insurgency, which seems to have grown markedly over the past year. We do not think it will grow strong enough to overthrow the government any time soon, but the longer the present disarray lasts, the more likely it is that civilian opposition to Marcos will move further to the left and take on more of an anti-US tone. It is too early to judge whether that would, in turn, focus on the major US bases in the Philippines, but such a contingency cannot be ruled out.

Nigeria

108. The prospects for political stability, economic recovery, and reasonably smooth debt servicing are probably the worst in Nigeria, among the major debtor countries. Fortunately, Nigeria's debt—now $18-25 billion including arrears—is not so large as to threaten international financial stability even if it were to be formally repudiated.

109. Nigeria developed a bad case of the "OPEC disease" in the 1970s. Booming oil revenues combined

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with an extraordinary level of public and private corruption and an overvalued currency (the naira) led to a severe decline in traditional exports (mainly agricultural), and rapidly growing imports of food and consumer goods. Oil accounts for close to 95 percent of export earnings and about 85 percent of total government revenues. The shift from oil shortage to oil glut hit Nigeria hard. Oil sales dropped from a peak of about $24 billion in 1980 to some $10 billion in 1983, while Nigeria's real GDP dropped an estimated 15 percent over the same period. Until 1983, imports did not decrease in step with export earnings, as Nigerian importers were able to obtain huge amounts of trade credits. But now, even trade credits are drying up in the face of mounting arrearages, and imports have been cut by about 50 percent.

110. The results have been inflation, rising unemployment, and falling output. Moreover, the fact that the naira continues to be greatly overvalued breeds widespread corruption, creates distortions in imports, and stimulates large capital flight. This worsening of economic conditions and the apparent increase in corruption were cited by the leaders of the military coup on New Year's Eve 1983 among their reasons for the overthrow of the Shagari government, reelected only in August 1983.

111. The new government, under Major General Buhari, has proved as cautious as its predecessor about making major policy changes, for fear of the domestic political repercussions. Buhari has reportedly said, perhaps facetiously, that if the new leaders had known just how bad the situation was they might not have carried out this coup.

112. Thus far, the new Nigerian Government has played heavily on the popular perception that most of Nigeria's current predicament can be blamed on the corruption and mismanagement of the ousted Shagari government. About 500 politicians and officials in that regime were arrested, and many are being tried for corruption by military tribunals. But even this effort to deflect attention and blame is likely to backfire: grumbling among lower-ranking officers and in sensitive civilian circles about the ethnic mix of those being tried, the continuation of corruption (if not quite as flagrant as before), and the worsening economy will sooner or later reflect on the present government. (See inset.)

Disarray in Nigeria

The decline in public confidence and in public hopes for eventual improvements in government performance were described as follows [redacted] 25X1 25X1

Nigerians in past economic good times have exhibited a remarkable tolerance for endemic corruption, political chicanery, and administrative inefficiency and mismanagement. There is increasing evidence, however, that public disenchantment with the seemingly inevitable cycle of failed civilian regimes followed by military regimes is growing and that this disillusionment goes beyond unhappiness with the performance of the government of the day. Moreover, special interest groups that offered early support for the coup increasingly have voiced growing skepticism as the regime's policies—or lack thereof—impact more directly on their welfare. Students and labor, in particular, have found it difficult to support measures that have included reintroduction of school fees, increased worker layoffs, and wage freezes. With little to offer Nigerians in the way of economic hope, the regime has been forced to rely heavily on symbolic ploys. The detailing of financial misdeeds of former civilian politicians, fanning Nigerian xenophobia by raising the specter of a mercenary-led invasion and "sinister forces" pushing an IMF agreement, and launching a highly publicized "war against indiscipline" have given the regime some time, but the impact is wearing thin. Moreover, even popular steps such as trying corrupt former politicians carry risks if it appears that the government has singled out certain ethnic or political groups for harsh treatment while overlooking misdeeds of others.

Economic Constraints

113. The Buhari government's economic policy choices are either very difficult to implement or are dangerous to its political survival. Nigeria's only real hope for raising additional revenue in the next two to three years is to increase the volume of oil exports. This will be difficult to do in a soft oil market. Nigeria has gotten away with periodically producing somewhat above its OPEC quota of 1.3 million barrels a day and gained a small, temporary increase in its quota at the last OPEC meeting. With the prices of light crudes sliding, however, this extra production has not helped much. The present Nigerian Government appears unwilling to risk a break with OPEC by increasing production substantially. But a future, less conservative government might take the risk, in the hope that other OPEC countries—especially Saudi Arabia—would support the existing oil price by cutting their own production, leaving Nigeria with larger exports.

114. A revival of traditional exports, especially cocoa and palm oil, would take years because these crops

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do not bear for several years after planting. Other agricultural exports and/or domestic food crops—peanuts, staple grains, and fibers—would require both time and a shift away from imports to revive. A major devaluation, coupled with steps designed to improve the real prices paid to farmers, would be essential conditions for progress in these areas. But devaluation is politically anathema. Labor, industry, and the whole government bureaucracy, with its strong interest in import-consuming urban living, all argue strongly against it. And, at least in the short run, devaluation would raise the prices of imported consumer goods, including food in the cities, worsen the plight of the import-dependent manufacturing sector, and reduce employment.

115. Without devaluing, Nigeria cannot expect to receive new credits from the IMF and the banks, because these institutions insist on a devaluation of between one-third and one-half as a precondition. Although creditor banks may agree to reschedule the large debt service arrears, a general debt rescheduling is not feasible, and debt servicing will continue to be difficult and probably chaotic.

116. Since it cannot hope to increase exports by much, and probably cannot accept IMF and creditor conditions for new loans, the government has no choice but to restrain imports. Yet imported essential spare parts, raw materials for industry, and some foods and consumer goods are already in very short supply.

117. The Buhari government avoided any mention of devaluation recently when it announced its economic program and budget for 1984. It clearly fears that a major devaluation would prompt another coup; it is probably right.

Political Constraints

118. [redacted] 25X1 25X1 Family and tribe are the strongest social institutions; ethnic rivalries are never far below the surface, even in the Army, which is perhaps the strongest national institution. The long and bloody civil war of the late 1960s was largely a struggle over control of the oil riches. Subsequent governments responded by creating many more states (and extra costly layers of government) in an effort to diffuse ethnic tension and spread the wealth. Nigerians of all tribal affiliations came to look on government as a provider of jobs and opportunities for enrichment. Now that the oil revenues are down, state and local governments are getting much less from Lagos. The oil wealth that, in effect, bought social peace has greatly diminished.

119. Rumors of coup plots by lower-ranking officers, disgruntlement over the northern bias in the Buhari government, and rising crime and social tension have already appeared. Despite the effort to catch and prosecute corrupt former officials (which at least some Nigerians seem to feel would solve the whole problem), corruption even at high levels remains a major problem.

Prospects

120. Nigeria is in for prolonged recession, inflation, high unemployment, and falling living standards as it is forced to adjust to lower oil revenues. Rising discontent and increased coup plotting seem inevitable. A successor government of lower-ranking military officers would have no more palatable options than the present military rulers have. It would, however, probably be even more nationalistic or xenophobic and hence more difficult for creditors to deal with.

121. While we do not rule out the possibility that the present Nigerian Government may manage to stay in power through the next several years, it seems more likely that Lagos will experience one or several more additional coups and deepening social fragmentation.

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Other Debtors

122. A number of other Latin American countries face political/economic constraints similar to those of the more troubled major debtors—Peru, Bolivia, and Ecuador are the most prominent. Peru's deteriorating economy—worsened by weather disasters in 1983 that destroyed infrastructure, food and export crops, and contributed to inflation—persistent insurgency, and a major election in Lima have severely eroded support for President Belaunde. The tentative agreement with the IMF includes unusually tough performance targets, and Lima is pushing hard for more generous terms. Presidential elections are scheduled for next April; opposition parties (particularly the Marxist United Left coalition that won the mayoralty in Lima) are gaining strength, and the moderate left APRA party is likely to win the presidency. An APRA government probably would be even more inclined than the present one to resist conditionality and engage in confrontation tactics with the IMF and the banks. In the meantime, Belaunde has precious little room to

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maneuver as consumer protests, strikes, and civil disorder mount.[5]

123. Bolivia has recently declared at least a temporary moratorium on servicing foreign bank loans in the face of mounting protests and strikes. Bolivia is facing near hyperinflation, crippling strikes, and general incapacity on the part of the government.

124. Elsewhere in the Third World, some minor debtors—Tanzania, Somalia, Sudan—have proved even more stubborn in dealing with their creditors, while a growing number of beleaguered LDC governments are pressing for softer terms, pleading for more understanding of their "special circumstances," and warning of political fallout unless they get more help. Urban protests and riots in Morocco, Tunisia, and, more recently, the Dominican Republic are cited as proof of the dangers of imposing austerity.

125. As time passes and especially if growth proves difficult to revive in many of the debtor countries, we expect stronger domestic political pressures for relief. IMF-sponsored programs that appear to delay or impede economic recovery are already under fire in a number of countries. Debtor governments have been quick to blame the banks, the IMF, higher interest rates, and trade barriers for much of their economic problems. We expect this trend to intensify and to further complicate relations with the creditors in almost all cases.

Implications for Debt Negotiations

126. Growing political resistance to IMF conditionality almost guarantees conflict between debtors and creditors over terms and conditions. Debtors will try to negotiate longer term reschedulings in order to free themselves from external pressures on their economic policies. They will try to minimize the burden of interest payments: by negotiating reduced spreads; by obtaining new credits; by getting banks to capitalize interest; and probably by proposing various new forms of creative adjustments, such as putting part of interest payments in "escrow" accounts in domestic currency payable later in hard currency as exports grow.

127. The bargaining power and strategy of the debtors are influenced by the creditors' and debtors' assessment of the costs, benefits, and risks of default, by the willingness of creditor governments to provide assistance, and by domestic, political, and foreign policy considerations. (See table 4.)

128. Default could occur under a wide variety of circumstances, which would greatly influence the outcome. Several debtor countries have already accumulated substantial arrears on interest payments and even announced temporary moratoriums on debt servicing. In some cases, creditors could have found these countries in legal default but did not do so. If a debtor did not meet its interest obligations for many months, the chances of default actions would increase. And, if the debtor country government formally repudiated debt obligations, legal default would become inevitable. In a default action, the creditors would try to attach whatever debtor country assets they could and would generally try to block transfers from the debtor's foreign deposits. The success of these actions would depend greatly on the degree of cooperation among the creditors, which would certainly be much greater in the event of repudiation than if the debtor accepted its obligations, claimed only inability to pay, and made at least token payments of interest.

129. Among the seven countries we are examining, at least four—Brazil, Mexico, Argentina, and Venezuela—have bank debts large enough so that default by any of them would seriously threaten the stability of several large banks, especially in the United States, and create major risks of a liquidity crisis in the international banking system. Clearly Mexico and Brazil have by far the greatest debtor's clout, while Chile, the Philippines, and Nigeria have the least.

130. Debtors' calculations as to the impact of default on their economies must take the following factors into account:

- The level and expected trend in interest rates, and their impact on the country's interest payments.
- The expected net inflow of foreign capital and the extent to which it eases the interest burden.
- The prospects for export earnings.
- The vulnerability of export earnings to disruption by creditors' actions in the event of default (for example, attaching assets, blocking financial transfers).
- The dependence of the country on foreign trade.
- The availability of trade credits for imports.
- The amount of material support likely to be forthcoming from other countries, including other debtors.

131. No one knows what the impact of a default by a major sovereign debtor would be: there is no prece-

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Table 4
Factors Affecting Debt Bargaining in Major Debtor Countries

	Size of Bank Debt (billion US dollars, end of 1983)	US Share (percent)	Gross Foreign Reserves, Mid-1984 (as percent of estimated 1984 imports)	Interest Payments Relative to Expected Net Capital Inflows, 1984 (percent)	Other Key Influences
Argentina	25.2	33	33	160	• High nationalism • High inflation • Maintenance of fledgling democracy • Low vulnerability of exports to disruption by creditors
Brazil	61.6	33	40	200	• Importance to United States • Evolving democracy
Chile	11.2	51	50	120	• Worst foreign financial position • Lower-than-expected copper prices
Mexico	65.2	39	45	No capital inflow	• Importance to United States • High vulnerability of exports to disruption by creditors, since most trade is with United States
Nigeria	9.1	21	10	No capital inflow	• Weak government's fear of popular reactions • Impossibility of raising export revenues • Worst financial mismanagement
Philippines	13.3	44	10	175	• Bases important to United States • Declining government effectiveness
Venezuela	26.5	42	150	Net capital outflow	• High nationalism • Best ability to be financially independent

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dent and opinions vary widely. Clearly, there would be a loss of trade and other credits and some disruption of trade, especially a decline in export earnings. On the other hand, interest payments would cease. Table 5 gives illustrative numbers. It suggests that most of the major debtors would be able to finance larger imports by cooperating with the creditors than by defaulting if external economic conditions were favorable (that is, rapid export growth, stable interest rates, and substantial capital inflows). In the case of all the countries except Mexico and Venezuela, export losses resulting from disruption due to default would have to be less than 20 percent or so for import capacity to be reduced. The picture is entirely different, however, if the debtors come to expect a pessimistic scenario to develop (that is, slow export growth, rising interest rates, and small or no capital inflows). For Mexico and Argentina, import capacity would be reduced by default *only* if export earnings were thereby cut drastically—by over 40 percent.

132. The debtor countries appear strongly disinclined to press the creditors to the point that default action would be likely, even when the basic arithmetic seems to favor default, because of fear of uncertainty and of possible isolation from the international community.

133. Among the seven countries, Argentina would be in the best position to withstand default. Its interest payments are large; net capital inflows are likely to be

Table 5
Parameters of Default in Major Debtor Countries, Optimistic and Pessimistic Projections for 1985 [a]

	A		B		B - A		B - A	
	Billion US Dollars						As a Percent of Exports	
	Net Capital Flow		Interest Obligations					
	Opt.	Pess.	Opt.	Pess.	Opt.	Pess.	Opt.	Pess.
Argentina	3.0	0	4.2	4.0	1.2	4.0	13	47
Brazil	6.0	3.0	11.3	11.7	5.3	8.7	17	30
Chile	2.0	1.0	2.0	1.9	0	0.9	0	23
Mexico	3.0	1.5	11.6	11.5	8.6	10.0	33	42
Nigeria	1.5	0	1.6	1.5	0.1	1.5	1	12
Philippines	2.0	1.0	2.0	2.0	0	1.0	0	18
Venezuela	0	0	4.1	4.1	4.1	4.1	25	26

[a] It is assumed that in a default situation the net capital flow would be zero and interest would not be paid. The difference between interest obligations forgone and the net capital inflow forgone is a gain resulting from default. This gain is calculated as a share of export earnings to show how much these would have to be reduced by creditors' actions to leave the debtor country no better off than without default.

small; exports are not very dynamic. Moreover, grain and food products constitute nearly two-thirds of exports and can be sold on the open market without identifying the source, and at least some of them might be shifted to the USSR. Standing up to creditors, even alone, would be politically popular among the nationalistic Argentines. Even Buenos Aires, however, is unlikely to take action leading to default unless external economic conditions turn sour.

134. For the other major debtors the risk of actions leading to default is probably small unless external economic conditions worsen markedly. Although there can always be miscalculations, both the debtors and creditors will probably go far to avoid a break because neither wants to accept the high risks such an action would bring.

135. The chances are that confrontations will force compromises involving repeated, small adjustments. One way or another will be found to cover part of interest obligations if these cannot be reduced. Where political pressures further restrict the freedom of action of debtor country governments, the creditors will have to make the greater adjustments.

136. A major factor in debt negotiations will be the debtors' expectations of special assistance from creditor country governments, especially that of the United States. Some major debtors, such as Mexico, the Philippines, and the debt-ridden countries of Central America and the Caribbean, are bound to factor special US economic, security, or other foreign interests into debt negotiations. They will use their leverage on the US Government to push for special bilateral economic concessions and to resist politically distasteful conditions from the IMF and from the banks. Other countries, with less claim to special treatment from the United States or another major industrial power, nonetheless will make the strongest case they can for such treatment. Argentina, for example, is playing hard on the theme that a liberal approach on the debt problem by creditors is essential to the preservation of Argentine democracy. There is a strong tendency among the debt-ridden developing countries, especially in Latin America, to exaggerate the importance of special US foreign policy interests as well as the degree of influence of the US Government on the actions of the IMF and the banks. Consequently, the United States is likely to get a great deal of blame if debtor countries' expectations are disappointed.

137. Another major uncertainty in debt negotiations is the role of cooperation among debtors. There has been a great deal of speculation about a so-called

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debtors cartel. In our opinion, a debtors' cartel in the strict sense is highly unlikely to be formed. Such a cartel would require agreement among a group of debtors to accept nothing short of certain minimum terms on new credits and reschedulings. To give teeth to such an agreement the debtors would have to be prepared to refuse any bilateral offer that was not also extended to other countries. If their conditions were not met, they would have to be prepared jointly to withhold debt servicing and risk default. Yet the economic interests of the debtors vary considerably because of the differing prospects for export earnings and capital inflows, the differing vulnerability of export earnings to creditor actions, and the differing extent to which various countries can expect special treatment from the US Government. Brazil and Mexico probably believe they have little to gain by belonging to a cartel because their individual bank debt is so large that the banks will be forced to make concessions in any event. Moreover, Mexico and Brazil would be reluctant to jeopardize their improved standing with the banks.

138. The best candidates for a debtors' cartel would probably be a group of medium-size Latin American countries under Argentine leadership. Argentina, Peru, Colombia, Chile, and Bolivia have an aggregate debt nearly as large as Brazil's or Mexico's. All five of them are either strongly resisting IMF conditionality or are in a particularly difficult financial position. Should Argentina give up on IMF negotiations it would probably seek support from at least some of these countries. Although they are more vulnerable than Argentina to creditors' actions in the event of default, these other countries could find the prospect of a cartel attractive. In this situation, the banks would certainly try to isolate Argentina by trying to make it an example and perhaps by offering "carrots" to some of the other debtors.

139. If external economic conditions turn sour to the extent that even Mexico and Brazil would consider actions leading to default, a broad debtors' cartel would become a real possibility. Whether or not a cartel were organized, major adjustments in debt servicing would become necessary.

140. The fact that a formal debtors' cartel is unlikely to develop does not preclude increased cooperation among debtors. Exchanges of information on credit terms and debt negotiations have been under way for some time, and regular consultative meetings were agreed on at the Cartagena conference. Better exchange of information obviously improves the debtors' bargaining position. Moreover, the debtors are certainly going to increase the degree of political pressure on creditor country governments to ease the debt burden. This pressure will occur in many forums—in the UN, at the economic summit, and elsewhere—and take many forms.

141. In any event the United States as the major developed power, home to the main creditor banks, and seen to be the main player in the IMF's decisions, is already being blamed for some of the debtor nations' economic trouble. As the debtor governments try harder to deflect blame from themselves, the United States will be the most likely scapegoat. We also expect rising nationalism in many debtor countries reflecting resentment of outside pressures. Particularly in Latin America, it is likely to take on more anti-US coloration.

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ANNEX

Balance-of-Payments Scenarios for Major Debtor Countries

We use optimistic and pessimistic scenarios to illustrate plausible balance-of-payments positions for key LDC debtors for 1985 and 1986. The scenarios are based on assumptions about changes in exports, interest rates, net capital flows, and foreign exchange reserves. Services (and private transfers) other than interest payments are held constant at the 1984 value. Import capacity is derived as a residual.

In the case of the optimistic scenario, the projected growth in exports is based on a continuation of OECD economic expansion at near 3 percent per year, as well as on each country's export mix. Interest rates are assumed to hold steady at the 1984 level. Net capital flows return to a normal level—that is, direct investment regains pre-1982 levels, commercial bank lending increases 5 to 10 percent per year, and short-term trade credits return to pre-1982 norms. Reserve levels are rebuilt as shown.

In the pessimistic scenario, the growth in exports is based on OECD economic growth of 1 to 2 percent annually. Interest rates are again assumed to hold at the 1984 level. Net capital flows are estimated to be half the optimistic level or near zero, according to the country's situation. There is no rebuilding of foreign exchange reserves.

Published IMF data are used where available; otherwise we use the latest country reporting. In both scenarios, future interest payments are obligations (not estimates of what may be paid).

The following country tables (tables 6-12) include the export assumptions used.

Table 6
Argentina: Balance-of-Payments Scenarios

Billion US dollars

	1983 Actual	1984 Estimate	Optimistic Projection		Pessimistic Projection	
			1985	1986	1985	1986
Exports	7.8	8.5	9.4	10.3	8.5	8.5
Imports	−4.1	−4.5	−5.7	−6.4	−2.5	−2.5
Trade balance	3.7	4.0	3.7	3.9	6.0	6.0
Interest payments	−3.8	−4.0	−4.2	−4.4	−4.0	−4.0
Other services	−2.4	−2.0	−2.0	−2.0	−2.0	−2.0
Service balance	−6.2	−6.0	−6.2	−6.4	−6.0	−6.0
Current account balance	−2.4	−2.0	−2.5	−2.5	0	0
Capital account balance	−0.2	2.5	3.0	3.0	0	0
Change in reserves [a]	2.6	−0.5	−0.5	−0.5	0	0

Export Assumptions	
Optimistic	10% annual growth
Pessimistic	No change

[a] Negative denotes an increase in reserves.

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Table 7
Brazil: Balance-of-Payments Scenarios

Billion US dollars

	1983 Actual	1984 Estimate	Optimistic Projection		Pessimistic Projection	
			1985	1986	1985	1986
Exports	22.0	26.5	31.8	38.2	29.2	32.1
Imports	−15.5	−15.5	−21.0	−27.7	−17.0	−20.6
Trade balance	6.5	11.0	10.8	10.5	12.2	11.5
Interest payments	−10.0	−11.0	−11.3	−12.0	−11.7	−11.5
Other services	−3.4	−3.5	−3.5	−3.5	−3.5	−3.5
Service balance	−13.4	−14.5	−14.8	−15.5	−15.2	−15.0
Current account balance	−6.9	−3.5	−4.0	−5.0	−3.0	−3.5
Capital account balance	6.5	5.5	6.0	7.0	3.0	3.5
Change in reserves [a]	0.4	−2.0	−2.0	−2.0	0	0

Export Assumptions	
Optimistic	20% annual growth
Pessimistic	10% annual growth

[a] Negative denotes an increase in reserves.

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Table 8
Chile: Balance-of-Payments Scenarios

Billion US dollars

	1983 Actual	1984 Estimate	Optimistic Projection		Pessimistic Projection	
			1985	1986	1985	1986
Exports	3.9	3.9	4.5	5.2	3.9	3.9
Imports	−2.8	−3.5	−3.2	−4.2	−2.2	−2.1
Trade balance	1.1	0.4	1.3	1.0	1.7	1.8
Interest payments	−1.6	−1.8	−2.0	−2.2	−1.9	−2.0
Other services	−0.5	−0.6	−0.8	−0.8	−0.8	−0.8
Service balance	−2.1	−2.4	−2.8	−3.0	−2.7	−2.8
Current account balance	−1.1	−2.0	−1.5	−2.0	−1.0	−1.0
Capital account balance	0.6	1.5	2.0	2.0	1.0	1.0
Change in reserves [a]	0.5	0.5	−0.5	0	0	0

Export Assumptions	
Optimistic	15% annual growth
Pessimistic	No change from 1984

[a] Negative denotes an increase in reserves.

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Table 9
Mexico: Balance-of-Payments Scenarios

Billion US dollars

	1983 Actual	1984 Estimate	Optimistic Projection		Pessimistic Projection	
			1985	1986	1985	1986
Exports	22.2	23.6	26.0	28.6	23.6	23.6
Imports	−7.7	−9.5	−17.4	−21.7	−14.6	−14.9
Trade balance	14.5	14.1	8.6	6.9	9.0	8.7
Interest payments	−9.9	−11.4	−11.6	−11.9	−11.5	−11.7
Other services	0.6	1.0	1.0	1.0	1.0	1.0
Service balance	−9.3	−10.4	−10.6	−10.9	−10.5	−10.7
Current account balance	5.2	3.7	−2.0	−4.0	−1.5	−2.0
Capital account balance	−3.2	0	3.0	4.0	1.5	2.0
Change in reserves [a]	−2.0	−3.7	−1.0	0	0	0

Export Assumptions	
Optimistic	10% annual growth
Pessimistic	No growth

[a] Negative denotes an increase in reserves.

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Table 10
Nigeria: Balance-of-Payments Scenarios

Billion US dollars

	1983 Actual	1984 Estimate	Optimistic Projection		Pessimistic Projection	
			1985	1986	1985	1986
Exports	11.6	13.5	16.0	16.0	13.0	13.0
Imports	−7.2	−9.5	−13.4	−13.3	9.5	9.5
Trade balance	4.4	4.0	2.6	2.7	3.5	3.5
Interest payments	−1.4	−1.5	−1.6	−1.7	−1.5	−1.5
Other services	−2.0	−2.0	−2.0	−2.0	−2.0	−2.0
Service balance	−3.4	−3.5	−3.6	−3.7	−3.5	−3.5
Current account balance	1.0	0.5	−1.0	−1.0	0	0
Capital account balance	−1.6	−0.5	1.5	1.5	0	0
Change in reserves [a]	0.6	0	−0.5	−0.5	0	0

Export Assumptions	
Optimistic	Based on oil production of 1.6 million barrels a day
Pessimistic	Based on oil production of 1.3 million barrels a day

[a] Negative denotes an increase in reserves.

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Table 11
Philippines: Balance-of-Payments Scenarios

Billion US dollars

	1983 Actual	1984 Estimate	Optimistic Projection		Pessimistic Projection	
			1985	1986	1985	1986
Exports	5.0	5.5	6.0	6.6	5.5	5.5
Imports	−7.5	−6.2	−7.2	−8.1	−6.2	−6.3
Trade balance	−2.5	−0.7	−1.2	−1.5	−0.7	−0.8
Interest payments	−1.7	−2.3	−2.0	−2.2	−2.0	−2.1
Other services	1.7	1.7	1.7	1.7	1.7	1.7
Service balance	0	−0.6	−0.3	−0.5	−0.3	−0.4
Current account balance	−2.5	−1.3	−1.5	−2.0	−1.0	−1.2
Capital account balance	0.9	1.3	2.0	2.5	1.0	1.2
Change in reserves [a]	1.6	0	−0.5	−0.5	0	0

Export Assumptions

Optimistic	10% annual growth
Pessimistic	No change

[a] Negative denotes an increase in reserves.

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Table 12
Venezuela: Balance-of-Payments Scenarios

Billion US dollars

	1983 Actual	1984 Estimate	Optimistic Projection		Pessimistic Projection	
			1985	1986	1985	1986
Exports	14.7	15.7	16.5	17.3	15.7	15.7
Imports	−6.8	−7.3	−10.2	−11.0	−9.4	−9.4
Trade balance	7.9	8.4	6.3	6.3	6.3	6.3
Interest payments	−3.0	−3.2	−4.1	−4.1	−4.1	−4.1
Other services	−1.2	−2.2	−2.3	−2.3	−2.2	−2.2
Service balance	−4.2	−5.4	−6.4	−6.4	−6.3	−6.3
Current account balance	3.7	3.0	0	0	0	0
Capital account balance	−3.8	−3.8	0	0	0	0
Change in reserves [a]	0.1	0.8	0	0	0	0

Export Assumptions

Optimistic	5% annual growth
Pessimistic	No change from 1984

[a] Negative denotes an increase in reserves.

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